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TAGS: ECON EINV ETRD EFIN SR
SUBJECT: SERBIA ALREADY MISSING IMF TARGETS, REVISED ARRANGEMENT LIKELY NECESSARY

REF: Belgrade 272

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SUMMARY
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¶1. (SBU) Just one month after approval of a $4 billion Stand By Arrangement with the IMF, it is already clear Serbia will be unable to meet the fiscal and GDP targets in the agreement and that a revised arrangement will be necessary by early fall. The National Bank of Serbia remains confident that it can maintain a stable currency, but expressed deep concerns about inflation and government debt financing. Private sector analysts believe the situation in Serbia may still get worse, as there appears to be little coordinated effort to promote economic growth. Without deep structural reforms to stimulate export led growth, Serbia may continue to face recession long after the rest of Europe recovers. END SUMMARY.


IMF Targets Not Being Reached
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¶2. (SBU) One month after concluding the $4 billion Stand by Arrangement, Serbia is already not meeting its IMF targets. Instead of a 3% fiscal deficit, Finance Minister Dragutinovic stated on May 28 that a "fiscal gap of 4% would be more appropriate for Serbia" and that Serbia would ask the IMF to approve an expansion of its fiscal deficit to 4% of its output. On June 11 Prime Minister Mirko Cvetkovic publicly stated that he expected the IMF would "understand" if Serbia requested to widen the fiscal deficit projection. Serbia is also off target regarding its GDP, which was initially expected to contract by 2 percent. Now, economic analysts are expecting a 5 percent contraction, which will put further constraints on government revenue projections.

¶3. (SBU) IMF Resident Representative, Bogdan Lissovolik told us on June 8 that Serbia would need to take broader adjustments if it exceeded the 3% fiscal deficit. Despite the government's April package of anti-crisis measures, which among other things included a 26% cut in each ministry's discretionary spending, the efforts appeared insufficient and already there were signs that expenditures were rebounding. Lissovolik said there was little evidence on the municipal level that spending was curtailed or that wages were frozen. Serbia would need to further control spending, implement adjustments on the revenue side, such as raising the VAT, as well as implement long delayed structural adjustments, such as pension, health, and civil service reform, Lissovolik said.

Central Bank: Monetary Side Stable, Fiscal Side Sloppy
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¶4. (SBU) National Bank of Serbia (NBS) Governor Radovan Jelasic

told us on June 10 that Serbia's monetary policy was stable and that the NBS did not require any additional technical assistance. "We can sleep well, knowing that Serbia's taxpayers had not used one Dinar to support the financial sector," Jelasic said. It was essential to focus on the fiscal side and to help the Ministry of Finance and Treasury, Jelasic said.

¶5. (SBU) The government was the country's largest foreign currency risk, Jelasic said, noting that over 90% of Serbia's public debt was based in foreign currency. Finally the government was taping the domestic market for funds, but at a staggering pace. In just three months the government had issued nearly $700 million in treasury bills. Jelasic said he expected public debt to increase by 15% of GDP this year. In absolute terms this would be a $6.36 billion increase, jumping from $12.5 billion in April 2009 to an estimated $18.86 billion by the end of the year. This new funding includes: the new IMF loan ($2.9 billion in 2009), loans from IFIs for infrastructure projects and budget support (around $1.38 billion), possible loans from Russia ($1.38 billion), and Treasury bills ($700 million as of June 2009).

## International Loans: From Russia, With Love?

¶6. (SBU) In addition to issuing Treasury bills, Serbia is considering using additional international credits to plug the budget holes and to begin much delayed infrastructure projects. Press reports about potential loans from Russia state that these loans, in addition to filling the budget gap, would be for the construction of the long discussed but prohibitively expensive metro project in Belgrade and other undetermined infrastructure projects. Jelasic told us he hoped the government would not use credits solely for additional consumption. He stressed however that any Russian credits would not come cheaply, noting that Armenia had recently received Russian loans at a significant cost (Libor +3 percent, 15



year repayment with a five year grace, according to what the Armenian Central Bank Governor told Jelasic.)

¶7. (SBU) Jelasic was cautious about Serbia's future economic forecast. From the monetary side, it all depended upon inflation, which could "hit hard," he said. Even though public wages and pensions were currently frozen until the end of 2010, "inflation keeps eating away," said Jelasic. Inflation for 2009 is estimated to be between 8-9%, driven mostly by administratively controlled prices, such as utilities and gas.

## Pensions are "Killing Serbia"

¶8. (SBU) Serbia's overburdening pension system is suffocating the country and would further make it difficult for Serbia to meet IMF targets, Jelasic said, echoing Lissovolik's call for greater structural changes. Jelasic said this pension burden would increase in this current environment of rising unemployment, frozen wages, and a growing unofficial economy that was not paying into the social security system. Nearly 45% of pensions payments were provided directly by the budget, Jelasic said, adding that there were 1.2 million pensioners for Serbia's 7.5 million citizens and only 2 million paying taxes.

## Private Sector Pessimistic

¶9. (SBU) The current economic environment in Serbia had done little to encourage greater investment or commercial lending by banks, Raiffeisen Bank's Deputy Chairman of the Board, Zoran Petrovic told us on June 10. Petrovic said the Vienna Agreement, in which ten banks agreed in April under IMF auspices to maintain their exposure in Serbia (reftel) had successfully stabilized the financial situation, but had done little to change Serbia's underlying economic fundamentals. The restricted supervisory measures imposed by the NBS and banks themselves, while useful for assuring a strong Dinar, also limited the funds available for domestic borrowers. (Serbia has the highest capital adequacy ration in the region,

nearly 21%, compared to the international standard of just 8%, according to Petrovic.) Petrovic said he also expected a 5% contraction in Serbia's GDP for 2009. Noting the steady increase of non-performing loans on the balance sheets of commercial banks, Petrovic expected the situation would become tougher in the next three to six months. Lending in Serbia was at a "standstill," said Petrovic.

Next Steps with IMF
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¶10. (SBU) The IMF will send a technical team in late June to look at the stress testing of the banks who agreed to the Vienna Agreement. Afterwards, an IMF review team will visit in late August, which will then present its findings to the IMF Board by the end of September, Lissovolik said. In addition, IMF Deputy Managing Director Murilo Portugal will visit Belgrade on July 2 to commemorate 125 years of the National Bank of Serbia. Jelasic said he hoped Portugal would use that visit to deliver some "tough messages" so the government can take action before the IMF review team's August arrival. If all goes well in September, the IMF would revise the arrangement so that additional IMF funds could be released this year, Lissovolik said. The IMF delivered the first tranche of $1.06 billion on May 20. Two additional tranches could be delivered by end of year, making the total amount withdrawn in 2009 $2.9 billion.

COMMENT
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¶11. (SBU) By signing the IMF agreement in March, Serbia may have stopped any potential balance of payments problem, but its work is far from over. To date, Serbia's weak commitment to meeting the fiscal targets agreed to with the IMF and the further contraction of GDP makes a revision of the standby agreement not only likely, but essential. Serbia must seriously address the underlying flaws in its public sector spending, such as pensions, and get on track to stimulate export led growth if it is to weather the ongoing economic storm. End Comment

BRUSH